

Initial Statement of Reasons
Adoption of Proposed Amendments to
California Code of Regulations, Title 18, Section 1618,
United States Government Supply Contracts

SPECIFIC PURPOSE AND NECESSITY

Regulation 1618

Unless an exemption applies, California imposes a sales tax on retailers, which is measured by their gross receipts from the retail sale of tangible personal property in California. (Rev. & Tax Code, § 6051.) As relevant here, Revenue and Taxation Code (RTC) section 6007 provides that the term "retail sale" means "a sale for any purpose other than resale in the regular course of business" and RTC section 6381 provides an exemption from sales tax for gross receipts from the sale of tangible personal property to the United States.

California Code of Regulations, title 18, section (Regulation) 1618, *United States Government Supply Contracts*, prescribes the circumstances under which a retailer may make non-taxable sales of tools, equipment, direct consumable supplies, and overhead materials to a United States Government supply contractor who will resell the tangible personal property to the United States Government in the ordinary course of the contractor's business (hereafter, "sales for resale to the United States"). The regulation generally provides that:

- A retailer's sales of tools, equipment, direct consumable supplies, and overhead materials to a United States Government supply contractor are sales for resale to the United States if the United States takes title to the tangible personal property pursuant to a United States Government supply contract prior to the time the contractor uses the property to perform the function or act for which the property was designed or manufactured; and
- A retailer's sales of tools, equipment, direct consumable supplies, and overhead materials to a United States Government supply contractor are not sales for resale to the United States if the contractor makes any use of the property to perform the function or act for which the property was designed or manufactured prior to the time that title to the property passes to the United States.

Regulation 1618 also provides specific guidance for determining when title to direct consumable supplies and overhead materials passes to the United States under a United States Government supply contract. In addition, the United States Government has uniform acquisition policies and procedures for its executive agencies, which are codified in chapter 1 of title 48 of the Code of Federal Regulations, the Federal Acquisition

Regulation (FAR); and Regulation 1618 provides specific guidance as to when title to “special tooling” passes to the United States under the FAR.

2007 Amendments to FAR

Regulation 1618 was last amended in 1995 to provide specific guidance for determining when title to overhead materials passes to the United States in accordance with the Court of Appeal’s decision in *Aerospace Corporation v. State Board of Equalization* (1990) 218 Cal.App.3d 1300, and when title to “special tooling” passes to the United States in accordance with FAR part 52.245-17. However, the federal government amended the FAR in 2007, and, among other changes, repealed FAR part 52.245-17, which contained special title passage clauses applicable to contracts for “special tooling,” and consolidated a number of clauses regarding the passage of title to the federal government into FAR part 52.245-1, effective June 14, 2007. Therefore, the State Board of Equalization (Board) directed its staff to meet with interested parties to discuss whether Regulation 1618 needs to be amended due to the repeal of FAR part 52.245-17 and any other changes in United States Government supply contracts.

At the conclusion of the interested parties process, Board staff prepared Formal Issue Paper 12-001, which raised the issue of whether the Board should amend Regulation 1618 to conform to changes in the FAR (the problem to be addressed for purposes of Government Code section 11346.2, subdivision (b)(1)), and recommended that the Board amend Regulation 1618 to:

- Delete the provisions in subdivision (a)(2) providing that the term “tools,” as used in the definition of direct consumable supplies, does not include “special tooling”;
- Add new provisions to subdivision (a)(2) specifying that, effective June 14, 2007, the term “tools,” as used in the definition of direct consumable supplies, includes “special tooling” that “was previously covered by FAR part 52.245-17”; and
- Amend the second to last sentence in subdivision (b) to reflect that the FAR’s title passage clauses for special tooling applied until Jun 13, 2007, but were no longer effective after that date.

In addition, Formal Issue Paper 12-001 recommended that the Board amend Regulation 1618, subdivision (a)(3) to clarify that costs for “overhead materials” must be allocated to United States Government supply contracts “consistent with government cost accounting standards.” It also recommended that the Board clarify the guidance provided in subdivision (b) regarding the passage of title to “direct consumable supplies” and “overhead materials” by separating subdivision (b) into paragraphs (1) through (3), explaining that overhead materials are one example of “indirect consumable supplies,” and providing distinct guidance regarding the passage of title to direct consumable supplies, which are directly reimbursable under specific contracts, and indirect consumable supplies, which must be allocated to specific contracts.

The Aerospace Industries Association (AIA) participated in Board staff's meetings with the interested parties and AIA agreed with staff's recommended amendments to Regulation 1618 as set forth in Formal Issue Paper 12-001.

Business Taxes Committee Meeting

The Board considered Formal Issue Paper 12-001 during its March 20, 2012, Business Taxes Committee meeting, and the Board unanimously voted to propose the adoption of staff's recommended amendments to Regulation 1618 because the Board determined that the amendments are reasonably necessary for the specific purposes of:

- Conforming Regulation 1618 to the 2007 amendments to the FAR, particularly the repeal of FAR part 52.245-17 regarding special tooling;
- Clarifying that costs for overhead materials must be allocated to United States Government supply contracts consistent with government cost accounting standards;
- Clarifying that overhead materials are one example of indirect consumable supplies; and
- Providing distinct guidance regarding the passage of title to direct consumable supplies and indirect consumable supplies, including overhead materials.

The proposed amendments are anticipated to provide the following benefits:

1. Ensure that Regulation 1618 is consistent with the amendments made to the FAR effective June 14, 2007;
2. Eliminate confusion regarding the treatment of special tooling after the 2007 amendments to the FAR;
3. Explain that overhead materials are one example of indirect consumable supplies; and
4. Provide more certainty regarding sales for resale to the United States of direct consumable supplies and indirect consumable supplies, including overhead materials.

The proposed amendments to Regulation 1618 were not mandated by federal law or regulations, although changes to federal regulations are one of the reasons why the proposed amendments are necessary. There is no previously adopted or amended federal regulation that is identical to Regulation 1618.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 12-001, the exhibits to the formal issue paper, and the comments made during the Board's discussion of the formal issue paper during its March 20, 2012, Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1618 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1618 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments at this time because the Board determined that the amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1618 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(6) AND ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The proposed amendments to Regulation 1618 make the regulation consistent with the 2007 amendments to the FAR, eliminate confusion regarding the treatment of special tooling after the 2007 amendments to the FAR, and provide more clarity and certainty regarding the requirements for sales for resale of direct consumable supplies and indirect consumable supplies, including overhead materials, to the United States. The proposed amendments were the result of a collaborative effort between Board staff and the interested parties and are intended to provide additional certainty to retailers. In addition, the proposed amendments will not impose any new taxes. Therefore, the Board has determined that the adoption of the proposed amendments to Regulation 1618 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

Furthermore, Regulation 1618 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1618 will not affect the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1618 will not have a significant adverse economic impact on business.

The proposed amendments may affect small business.